In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION[1] IN SUPPORT OF THE PETITION

1. The Securities and Exchange Commission supports the petition of Mortimer M. Caplin, appointed under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, as trustee of Webb & Knapp, Inc., for

[1] The Securities and Exchange Commission is participating in the reorganization proceeding in the district court as a party pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, and has taken positions in that court and in the court of appeals similar to the positions urged herein. As in *Protective Committee* v. *Anderson*, 390 U. S. 414, 420 n. 3, the Commission is "an unnamed respondent before this Court." See Rule 21(4) of the Rules of this Court.

444-748—71

review of the *en banc* holding below that petitioner lacks standing to assert claims on behalf of holders of debentures issued to the public by Webb & Knapp against Marine Midland Grace Trust Company of New York as trustee under the indenture pursuant to which the debentures were issued. It believes that the case presents an important issue in the administration of the corporate reorganization provisions of the Bankruptcy Act that this Court should resolve.

The claims asserted by petitioner against Marine Midland were based on a covenant contained in the indenture for the benefit of the debenture holders which prohibited Webb & Knapp from purchasing real property or incurring certain indebtedness at any time when its consolidated tangible assets were less than 200 percent of certain liabilities (Indenture, Section 3.6; Pet. App. 11a, n. 1). Petitioner alleged that Marine Midland had breached its duty under the indenture to enforce the covenant by not challenging certificates submitted by Webb & Knapp to establish compliance which were based on—and which Marine Midland should have known were based on—grossly inflated appraisals of Webb & Knapp's assets (Pet. App. 11a–12a, n. 1). Petitioner's claims for $4,398,200, the amount of the outstanding debentures (Pet. App. 11a), were asserted in a counterclaim to a claim asserted in the reorganization proceedings by Marine Midland for certain services, and in a plenary suit which the district court had authorized petitioner to file. Petitioner also moved in the reorganization proceeding that Marine Midland be

required to file an accounting to which petitioner intended to assert these claims as a counterclaim (Pet. App. 12a).

The district court, in three separate orders, dismissed the counterclaim[2] and plenary suit and denied the motion for an accounting (Pet. App. 1a, 4a, 8a). On consolidated appeals, the court of appeals, in an *en banc* decision, followed its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (C.A. 2), and affirmed the district court's orders (Pet. App. 11a–22a). Judges Kaufman and Hays dissented (Pet. App. 22a–28a).

2. The decision below seriously restricts the ability of Chapter X trustees to protect the interests of public investors in debtors and equitably to adjust a debtor's affairs and conflicts in principle with the decision of the Third Circuit in *In re Solar Manufacturing Corp.*, 200 F. 2d 327, certiorari denied, 345 U. S. 940.[3] Moreover, several district court cases have dealt with similar issues involving the standing of the Chapter X trustees, reaching inconsistent results (see

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[2] Petitioner was permitted to assert his claims as an affirmative defense to Marine Midland's $51,448 claim for certain services (Pet. App. 6a–7a).

[3] See *In the Matter of Manufacturers Credit Corporation, v. Securities and Exchange Commission*, 395 F. 2d 833, 842 (C.A. 3), where the court, in comparing advantages to public investors to be found in Chapter X against their position in a proceeding under Chapter IX of the Bankrupty Act, noted that action for "* * * potential remedies which the Securities Act of 1933 may afford innocent investors against those from whom they purchased the notes * * * and for others, which may be disclosed by his investigation, can be more effectively prosecuted by a Chapter X trustee than by the individuals concerned."

Pet. 8–9). Accordingly, review by this Court is warranted.

a. In denying petitioner standing, the court below failed to recognize the critical role that Chapter X trustees play in protecting the interests of public investors. As was emphasized in the House Report on what became the Chandler Act, 52 Stat. 883, revising Chapter X (H. Rep. No. 1409, 75th Cong., 1st Sess., p. 43):

> There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest. * * *

The numerous debenture holders in this case are presumably widespread and, at least in New York, face uncertain legal obstacles to the institution of a class action against Marine Midland (see Pet. 5, n. 3). Under these circumstances, petitioner is the only one who can effectively protect the interests of the debenture holders and accordingly should be granted standing to maintain an action on their behalf in the district court.

In holding that petitioner lacks standing to assert the claims of the debenture holders against Marine Midland because the claims did not concern property of Webb & Knapp, the court below emphasized its view that a recovery would benefit only the debenture holders and not the estate as a whole, as Marine Midland—to the extent found liable to the debenture

holders—would merely be subrogated to the debenture holders' claims against the estate (Pet. 17a–18).[4] But, even if other creditors would not benefit as a result of the recovery by the debenture holders, the other creditors would be in no worse position and the debenture holders would be in a better position, since they might receive as much as one hundred cents on the dollar instead of the fraction of that amount which may be distributed in the reorganization.[5] The fate of a substantial body of public creditors—the debenture holders—may be a critical factor in developing a successful reorganization plan, for, as Judge Kaufman pointed out in his dissent (Pet. App. 25a–26a), recovery by the debenture holders could have a substantial effect on the view of interested parties and the courts in considering the fairness of the overall reorganization plan. Thus, the majority's literal reading of Sections 216(2) and (13) of the Bankruptcy Act, 11 U.S.C. 616(2) and (13) (Pet. App. 20a), to deny petitioner standing to protect the debenture holders, unduly confines the scope of the reorganization process.

b. The harsh rule announced in *Clarke* had in effect been ameliorated (before being reaffirmed by the deci-

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[4] This conclusion may be unsound, however, as negligent conduct—such as that alleged here—may bar a party from asserting the equitable doctrine of subrogation. See *German Bank* v. *United States*, 148 U. S. 573; *A. Gusmer, Inc.* v. *McGrath*, 196 F. 2d 860 (C.A.D.C.).

[5] The burden on the estate of litigating the debenture claims would appear to be minimal, for petitioner would have to prove the same facts in his objection to Marine Midlands' proof of claim (see n. 2, *supra*).

sion below) by a subsequent opinion of Judge Learned Hand (who vigorously dissented in *Clarke*) in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (C.A. 2), holding that a Chapter X trustee had standing on behalf of certain bondholders to sue an indenture trustee for failure to pursue a guarantee of a defaulted mortgage pledged by the debtor as collateral for the bonds. In a similar decision, the Third Circuit held in *In re Solar Manufacturing Corp., supra,* that a Chapter X trustee could assert the claims of debenture holders against the indenture trustee for failure to earmark certain funds of the debtor for the debenture holders as required by the indenture.

The court below sought to distinguish both *Prudence-Bonds* and *Solar* on the theory that the Chapter X trustee in each case was asserting a claim to a part of the trust "res."[*] The court conceded that, if Marine Midland had held property of Webb & Knapp through a pledge or as the result of payments into

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[*] In *Prudence-Bonds*, the indenture trustee had had possession of the mortgages pledged by the debtor, and the guaranty to pay defaulted principal and interest on the mortgages was considered as part of the "res." But, as noted in the dissent below (Pet. App. 25a), the action in *Prudence-Bonds*, as here, was one for an accounting for the loss to the bondholders that resulted from the indenture trustee's breach of duty and was not an action for restoration of the trust fund or the debtor's property. Similarly, although the court in *Solar* described the cause of action there as "quasi in rem for the benefit of the trust" and "for the restoration of trust funds," 200 F. 2d at 332, the suit was brought by the Chapter X trustee for the benefit of the debenture holders to whom the indenture trustee owed a fiduciary duty.

a sinking fund, petitioner would have standing to sue (Pet. App. 17a). The above distinctions are, in our view, attenuated and have no basis in logic or policy. In each of the three cases—*Prudence-Bonds, Solar* and the instant case—the Chapter X trustee's primary concern in attempting to sue the indenture trustee was to protect the interests of the public investors; in each case, recovery was sought from the indenture trustee for the benefit of the bondholders. To permit recovery only when the alleged breach of duty can be traced to property which at one time had been in possession of the indenture trustee is to draw an artificial line between groups of investors—protecting those on one side but not the other. The Bankruptcy Act, however, was intended to benefit all classes of creditors. See *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 114.

It is therefore respectfully submitted that the petition for a writ of certiorati should be granted.

ERWIN N. GRISWOLD,
Solicitor General.

G. BRADFORD COOK,
General Counsel,
Securities and Exchange Commission.

SEPTEMBER 1971.

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